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Report to the Chairman, Legislation and
National Security Subcommittee
Committee on Government Operations
House of Representatives

May 1992

CONTRACT PRICING

Issues Related to the Defense Contract Audit Agency



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The Honorable John Conyers, Jr.
Chairman, Legislation and National
Security Subcommittee
Committee on Government Operations
House of Representatives

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Dear Mr. Chairman:

As you requested, this report contains key issues that we have identified in our reports on contract pricing over the last year and a half. Specifically, it focuses on the work of the Defense Contract Audit Agency (DCAA) and matters in our reports that directly affect the operations and management of DCAA.

Background

Because many weapons and related systems are complex, one-of-a-kind products, many Department of Defense (DOD) purchases come from one supplier and are not influenced by the competitive forces of the marketplace. Contract prices for noncompetitive procurements are generally determined through extensive negotiations.

Historically, a principal concern in noncompetitive procurements has been the limited cost or pricing information supporting contractors' proposals that is available to the government at the time of negotiations. Recognizing the government's vulnerability when it does not have accurate, complete, and current cost or pricing data on noncompetitive contracts, the Congress passed the Truth in Negotiations Act, Public Law 87-653, in 1962. The act, as amended and codified as 10 U.S.C. 2306a, is intended to protect the government against inflated contract estimates by requiring contractors and subcontractors to submit cost or pricing data supporting their proposed prices above certain dollar thresholds, with some exceptions, and to certify that the data submitted is accurate, complete, and current. Defective pricing occurs when a contract price is increased because the contractor does not provide accurate, complete, and current cost or pricing data, as required by the Truth in Negotiations Act. If the contract price is overstated because the data is not accurate, complete, and current, the government can reduce the contract price.

The existence of sound contractor cost-estimating systems is a major internal control mechanism for ensuring fair and reasonable

noncompetitive contract prices. In March 1988, in response to our reports and other audit reports showing evidence of overpricing, DOD revised its regulations to require major contractors to establish, maintain, and disclose adequate cost-estimating systems. DOD regulations also require contractors, under certain circumstances, to obtain and evaluate noncompetitive subcontract prices and include the results of the evaluations as part of their contract proposals. Such evaluations should be made before DOD and the prime contractor agree to a contract price because the evaluations can assist the contracting officers in assuring that only fair and reasonable subcontract estimates are priced into contracts.

As the role of many prime contractors has changed in the past several decades from fabricating weapons and products to integrating work done by subcontractors, subcontract costs have become substantial. They frequently comprise more than 50 percent of prime contract values. Active DOD subcontracts totaled \$193 billion at the end of fiscal year 1990. As a result, the estimates included in contractor proposals for subcontracts are a critical element in establishing the reasonableness of contractor prices.

DCAA was established in 1965 for the purpose of performing all contract auditing for DOD and providing accounting and financial advisory services, in connection with the negotiation, administration, and settlement of contracts and subcontracts, to all DOD procurement and contract administration activities. As a part of this effort, DCAA audits contracts and subcontractors for compliance with the Truth in Negotiations Act and it periodically evaluates contractor estimating systems. It also performs operations audits to evaluate the economy and efficiency of a specific contractor function or operation. DCAA also furnishes contract audit service to other government agencies. During the 1980s, DCAA staff levels doubled from about 3,500 to 7,000 work years. However, beginning in fiscal year 1991, staff levels declined by about 7 percent and further reductions are planned for fiscal years 1992 and 1993.

Results in Brief

Despite the existence of laws and regulations designed to protect the government from contract overpricing, DCAA reports issued in fiscal years 1987-90 identified \$3 billion in defective pricing. While the total dollar amount of defective pricing detected by DCAA was higher in prime contracts, defective pricing in subcontracts occurred slightly more frequently and at a higher dollar amount per contract. In addition, the smaller the subcontract, the higher the percentage of identified defective pricing.

Even though DCAA finds large amounts of defective pricing in its audits, substantial numbers of contracts and subcontracts, especially those of lower dollar values, do not get audited.

Additionally, subcontract proposals are overstated by millions of dollars, in part, because prime contractors often fail to adequately evaluate subcontractor proposals before contract negotiations, as required by the Federal Acquisition Regulation. Prime contractors then negotiate lower subcontract prices after contracting with the government.

DCAA reports identifying contractor cost-estimating systems deficiencies are not always clear as to the need to correct these deficiencies. Further, many DCAA reports do not recommend disapproval of contractors' estimating systems where DCAA finds them to contain significant deficiencies. DCAA's use of operational audits, which have proven valuable in identifying inefficient contractor operations, has decreased.

Contractor and Subcontractor Noncompliance With the Truth in Negotiations Act

Despite the existence of the Truth in Negotiations Act, defective pricing in both prime contracts and subcontracts has caused contract prices to be overstated by billions of dollars. In fiscal years 1987-90, DCAA conducted 8,333 defective pricing audits, of which 6,267 audits covered prime contracts and 2,066 covered subcontracts. These audits identified \$3 billion in defective pricing. DCAA found defective pricing in over 40 percent of the contracts it audited. Of the \$3 billion, \$2.1 billion represented prime contract defective pricing and \$880 million represented subcontract defective pricing.¹

Defective Pricing Occurs Often in Subcontracts

Defective pricing occurs slightly more frequently in subcontracts than in prime contracts, regardless of contract size. DCAA found defective pricing in 41 percent of the prime contracts audited and in 43 percent of the subcontracts audited in fiscal years 1987-90—an average of \$806,000 for each defectively priced prime contract and an average of \$991,000 for each defectively priced subcontract.

In addition, subcontract defective pricing dollars reported by DCAA have increased. In fiscal year 1990, DCAA reported subcontract defective pricing totaling \$264 million, an increase of \$83 million from the \$181 million DCAA reported in fiscal year 1987. On a per subcontract basis, the amount of

¹Contract Pricing: Subcontractor Defective Pricing Audits (GAO/NSIAD-91-148FS, Mar. 21, 1991).

defective pricing increased from about \$870,000 in fiscal year 1987 to over \$1.1 million in fiscal year 1990.²

Defective Pricing Rate Is Higher in Smaller Subcontracts

Although DCAA found defective pricing in all sizes of subcontracts, the amount of defective pricing, as a percentage of contract value, was higher in smaller subcontracts. For example, in fiscal years 1987-90, defective pricing was, on average, 11.8 percent of the total value of defectively priced subcontracts under \$10 million. By comparison, defective pricing in subcontracts valued at \$100 million or more, averaged 1.5 percent of the total value of defectively priced subcontracts during the same period.

Furthermore, the percentage of defective pricing for subcontracts under \$10 million increased as the size of the subcontract decreased, rising to 25 percent of subcontract value for subcontracts valued at \$500,000 and under,³ as shown in table 1.

Table 1: Average Defective Pricing as a Percentage of Subcontract Value Between Fiscal Years 1987-90

Subcontract value	Defective pricing as a percent of subcontract value
\$5 million to \$10 million	10.2
\$1 million to \$5 million	13.1
\$500,000 to \$1 million	17.9
\$500,000 and under	25.1

The extent of defective pricing found in contracts \$500,000 and under is especially significant because the fiscal year 1991 National Defense Authorization Act (P.L. 101-510) mandated that the threshold for submission of certified cost or pricing data be raised from \$100,000 to \$500,000, subject to a sunset provision returning the threshold to \$100,000 after December 31, 1995. This means that through 1995, contracts \$500,000 and under will not normally require certified cost or pricing data, and, therefore, will not be subject to defective pricing audits by DCAA. The DOD Inspector General is required under Public Law 101-510 to review the effects of the increase in the threshold and to submit a report to the Secretary of Defense, who in turn, is required to submit the report to the Congress. The report is due to the Congress upon its completion, but not later than the date on which the President submits the budget to the Congress for fiscal year 1996.

²GAO/NSIAD-91-148FS.

³GAO/NSIAD-91-148FS.

DCAA Coverage of Contracts and Subcontracts Subject to the Truth in Negotiations Act Is Limited

The portion of total DCAA field office staff resources devoted to defective pricing was about 10 percent in fiscal year 1990, compared with about 7 percent in fiscal year 1987.

In deciding which contracts to audit for defective pricing, DCAA classifies contractors based on its assessment of risk. For high-risk contractors, DCAA's fiscal year 1990 audit selection criteria called for audits of all fixed-priced contracts of \$10 million or more. The selection criteria also called for audits for 1 in 10 high-risk contracts between \$1 million and \$10 million, and only 1 in 50 high-risk contracts between \$100,000 and \$1 million. While DCAA allocated all the resources needed to audit high-risk contracts over \$10 million in fiscal year 1990, because of resource constraints, it was able to allocate only 61 percent of the resources for audits of high-risk contracts under \$10 million.⁴ DCAA's audits of lower-risk contractors are even less frequent.

DCAA recently modified its risk assessment procedures and is giving increased attention to contracts under \$10 million. However, substantial numbers of contracts still do not get audited for defective pricing.

Subcontract Costs Continue to Be Overstated

In addition to violations of the Truth in Negotiations Act, subcontract costs are overstated in contracts with the government when prime contractors obtain lower prices with subcontractors after negotiating with the government using higher subcontract prices. Overstated subcontract costs occur on both prime contractor identified prospective competitive subcontracts and on prospective noncompetitive subcontracts.⁵

If the prime contract is a firm fixed-price contract, the prime contractor retains all the savings. If it is a fixed-price incentive type contract, the prime contractor may share part of the price reduction with the government. Most DOD contracts are some type of fixed-price contract.

Overpriced subcontract proposals result, in part, when prime contractors fail to adequately evaluate noncompetitive subcontractor proposals prior to contract negotiations and provide that information to the government, as required by the Federal Acquisition Regulation.

⁴GAO/NSIAD-91-148FS

⁵Contract Pricing: Inadequate Subcontract Evaluations Often Lead to Higher Governmental Costs (GAO/NSIAD-91-161, Apr. 5, 1991).

Despite DOD's efforts to strengthen its regulations on cost-estimating systems and increased emphasis on subcontract pricing, we found that DOD contract prices continue to be overstated because of inflated subcontract estimates⁶ and that serious estimating deficiencies persist.⁷

Prime Contractors Obtain Price Reductions on Prospective Competitive Subcontracts After Negotiating With DOD

Prime contractors are required to obtain, in certain circumstances, cost or pricing data supporting subcontractor proposals, to evaluate the data, and to provide the evaluation results as part of their contractor proposals. Such requirements, however, do not apply to subcontracts awarded on the basis of adequate price competition because competition, in large measure, is presumed to produce fair and reasonable prices.

However, we found that the government did not receive the full benefits of competition because the contractor, after agreeing on price with the government, obtained lower prices from its prospective subcontractors. We examined 13 competitive subcontract estimates and found that prime contractors negotiated subcontract prices that were about \$3 million less than amounts negotiated in DOD contracts.⁸

In another report, we found that after competitively soliciting subcontract prices to support its proposals to the government, a contractor resolicited prices and, on 55 subcontracts, obtained prices, from the same or different bidders, that were \$10.4 million lower than what was proposed and included in the prime contracts.⁹ Because the contractor did not obtain the second set of lower quotations for many items until after price agreement with the government, these price reductions are not recoverable under the Truth in Negotiations Act. This is not a new issue.

In 1985, we testified that contractors were negotiating subcontract prices less than the amounts negotiated in prime contracts, and we again testified on this in April 1987.¹⁰ More recently, the DOD Inspector General found defense contractors continuing this practice.¹¹

⁶GAO/NSIAD-91-161.

⁷Contract Pricing: Defense Subcontract Cost-Estimating Problems Are Chronic and Widespread (GAO/NSIAD-91-157, Mar. 28, 1991).

⁸GAO/NSIAD-91-161.

⁹Contract Pricing: Competitive Subcontract Price Estimates Often Overstated (GAO/NSIAD-91-149, Mar. 20, 1991).

¹⁰GAO's Review of Contractor Cost-Estimating Systems (GAO/T-NSIAD-87-25).

¹¹Evaluation of Subcontract Price Proposals (DOD IG Report No. 90-057, Apr. 9, 1990)

Prime Contractors Awarding Noncompetitive Subcontracts at Lower Cost	<p>In addition to receiving additional profits on competitive subcontracts, prime contractors are also negotiating substantial price reductions on noncompetitive subcontract proposals after completing negotiations with the government.</p>
	<p>We examined 12 noncompetitive subcontract estimates, each in excess of \$1 million. We found that in the aggregate, prime contractors made awards on these estimates for about \$8.8 million less than the prices negotiated in the contract with DOD. In 9 of the 12 cases, subcontract evaluations were not completed before contract negotiations.</p>
	<p>On one contract, the prime contractor did not complete required evaluations on five subcontractor proposals valued at \$59.8 million before negotiating with DOD. Instead, the contractor made preliminary evaluations on four of the subcontract proposals and recommended reductions ranging from 1 percent to 5 percent. No preliminary evaluations were made on the fifth subcontract proposal. After DOD contract negotiations, the contractor conducted in-depth evaluations of updated proposals on the four subcontracts. Based primarily on the subsequent in-depth evaluations, the prime contractor negotiated average reductions of 14 percent in subcontract prices, or about \$3.1 million lower than amounts negotiated in the government contract.¹² Unless it can be shown that the contractor did not provide accurate, complete, and current cost or pricing data at the time of negotiations, these price reductions are not recoverable under the Truth in Negotiations Act.</p>
DCAA Finds Serious Contractor Estimating Deficiencies	<p>In March 1991, we reported that, despite the March 1988 revision to DOD's cost-estimating regulation, serious estimating deficiencies persist. We analyzed DCAA assessments of 101 contractor estimating systems performed between March 1989 and February 1990 to determine whether contractors had provided subcontract cost estimates that were reliable bases for negotiating fair and reasonable contract prices. We found that of the 101 contractors that DCAA reviewed, 83 had subcontract estimating deficiencies requiring corrective action. Forty-two contractors had deficiencies severe enough for DCAA to consider their systems unacceptable for producing proposals that provided reliable bases for negotiating fair and reasonable prices.¹³</p>

¹²GAO/NSIAD-91-161.

¹³GAO/NSIAD-91-161.

Improving DCAA's Effectiveness

Other audits we conducted over the last few years show that DCAA could improve its effectiveness by (1) improving its cost-estimating reports and (2) performing additional operations audits.

DCAA's Estimating Reports Can Be Improved

We found that DCAA estimating system reports that identified subcontract estimating deficiencies did not always demonstrate and emphasize to administrative contracting officers and contractors the need to correct these deficiencies. This shortcoming occurred because the reports were often not prepared in accordance with two of the agency's reporting procedures. Specifically, many DCAA reports did not illustrate the potential cost impact of the identified deficiencies or contain appropriate recommendations for disapproving inadequate systems.¹⁴

We recommended that DCAA headquarters emphasize to its field audit offices the importance of providing examples of cost impact to demonstrate the significance of the deficiencies cited. We also recommended that DCAA headquarters monitor estimating reports issued by its field offices until improvements are noted in field audit offices' compliance with regulatory requirements for recommending disapproval of contractor systems containing significant estimating deficiencies. DCAA has issued guidance to address these recommendations. The key issue at this point is the degree to which field offices implement the guidance.

Benefits of Additional DCAA Operations Audits

Operations audits, conducted by DCAA, are designed to evaluate the economy and efficiency of a specific contractor function or operation, such as overhead factors. The reviews can result in recommendations to eliminate unnecessary costs or waste, such as implementing new, emerging technologies for changing contractor practices. For example, the DOD Inspector General reported that DCAA issued 348 operations audit reports that identified avoidable costs of \$244.8 million during the 12-month period ending March 30, 1984. More recent operations audits have continued to result in cost savings.

We found that although operations audits have had substantial payback in identifying contractor inefficiencies, DCAA has decreased the number of operations audits it performs. We recommended that DCAA increase the priority of significant cost reduction measures, such as operations audits.

¹⁴Contract Pricing: Defense Contract Audit Agency's Estimating Reports Can Be Improved (GAO/NSIAD-91-241, Aug 1, 1991).

DOD agreed that operations audits have successfully identified ineffective or uneconomical contractor practices and had reduced costs for both contractors and DOD. However, DOD stated that it must devote its resources on the basis of perceived risk, available staff, and other factors.¹⁵

Scope and Methodology

In preparing this report, we reviewed 12 reports we issued on contract pricing or DCAA over the past year and a half to identify key issues involving the work of DCAA and matters affecting its operations and management. (See related GAO products.)

As agreed with your office, we did not obtain written agency comments on a draft of this report. We did, however, discuss the contents of the report with DOD and DCAA representatives.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days from the date of this letter. At that time, we will send copies to the Secretary of Defense; the Directors of the Defense Logistics Agency and DCAA; the Director, Office of Management and Budget; and other interested congressional committees. Copies will also be made available to others upon request.

Please contact me at (202)275-8400 if you or your staff have any questions concerning this report. The major contributor to this report was Charles W. Thompson, Assistant Director.

Sincerely yours,



Paul F. Math
Director, Research, Development, Acquisition
and Procurement Issues

¹⁵Contract Pricing: Economy and Efficiency Audits Can Help Reduce Overhead Costs (GAO/NSIAD-92-16, Oct. 30, 1991).

Related GAO Products

Contract Pricing: Threshold for Analysis of Subcontract Proposals Not Clear (GAO/NSIAD-92-69, Mar. 20, 1992).

Contract Pricing: Economy and Efficiency Audits Can Help Reduce Overhead Costs (GAO/NSIAD-92-16, Oct. 30, 1991).

Contract Pricing: Defense Contract Audit Agency's Estimating Reports Can Be Improved (GAO/NSIAD-91-241, Aug. 1, 1991).

Defense Contract Audits: Defense Contract Audit Agency's Staff Qualifications, Experience, Turnover, and Training (GAO/AFMD-91-72, July 19, 1991).

Contract Pricing: Thermal Panel Price Overstated on Trident II Missile Launcher (GAO/NSIAD-91-147, May 16, 1991).

Contract Pricing: Inadequate Subcontract Evaluations Often Lead to Higher Governmental Costs (GAO/NSIAD-91-161, Apr. 5, 1991).

Defense Contract Audits: Current Organizational Relationships and Responsibilities (GAO/AFMD-91-14, Apr. 3, 1991).

Contract Pricing: Defense Subcontract Cost-Estimating Problems Are Chronic and Widespread (GAO/NSIAD-91-157, Mar. 28, 1991).

Contract Pricing: Competitive Subcontract Price Estimates Often Overstated (GAO/NSIAD-91-149, Mar. 20, 1991).

Contract Pricing: Opportunities to Reduce Dual-Source Contract Prices (GAO/NSIAD-91-159, Mar. 28, 1991).

Contract Pricing: Subcontractor Defective Pricing Audits (GAO/NSIAD-91-148FS, Mar. 21, 1991).

Contract Pricing: Status of DOD Defective Pricing (GAO/NSIAD-91-33FS, Jan. 15, 1991).